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Economic Conditions
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General Business Conditions

THE influence of cutbacks in war orders is becoming more apparent in industrial reports as the weeks pass, and a downward trend in manufacturing activity is now well established. The industrial production index of the Federal Reserve Board dropped four points in April, four points more in May, and doubtless will show another decline when the returns are in for June. This trend is almost certain to continue. New estimates of requirements for the Pacific war have led to further revisions of munitions schedules, which are now placed by the War Production Board at 20 per cent below the March level in the third quarter of this year and 30 per cent below in the fourth quarter. These figures compare with a falling off of about 7 per cent during the quarter just ended. Further cuts in the early months of next year, and probably before, are in prospect.

In a report issued at the end of May Mr. Krug, chairman of W.P.B., indicated that munitions production during the last eight months of the year would average less than 10 per cent below the March peak. However, it was understood at the time that the Army Service Forces were reexamining their needs and that additional cuts were to come. Even before output of finished munitions is cut back, the effects are felt in cancellations and drying up of new orders for parts, components and materials; for the first move of prime contractors is to readjust subcontracts and purchase orders to the new schedules, while finished goods are completed out of materials on hand.

These cutbacks will dominate industrial trends during the next few months. Manufacturers getting out of war work will be getting into civilian production, or getting ahead with their reconversion programs, as rapidly as they can. On balance, however, production will be declining. It is not practically possible to make the change-over and at the same time to maintain the overall level of activity, for plants due for reconversion must be rearranged, war machinery and inventory removed, new machinery installed, new materials procured, and workers shifted and retrained.

For more than three years production has been directed toward war needs and the output of materials and the distribution of labor have been brought into balance for that purpose. Now a new balance to fit new conditions must be worked out. The task would be formidable even if the industrial organization were freed from all war demands; and the difficulties are greater because war needs will continue to use a huge proportion of the country's resources. Manufacturers will be released from war work, but others on whom they depend for parts or materials will still be producing for the Government. This is the "bottleneck" problem.

The State of Sentiment

One of the favorable features of the situation is the fact that business men are not looking upon the decline in war work with fear or dismay, but in many cases at least with relief. Under ordinary conditions the news that the biggest customer of the industries was on the point of reducing his purchases by $1½ billion monthly would have an almost paralyzing effect, but now there are many offsets. The drop is the visible sign that the stupendous cost and waste of the war are at last beginning to be reduced and the energies of the country freed in part for the production of goods which will add to civilian supplies, combat the inflationary menace, and resume the historical upward trend of the standard of living. In their own interest as well as the interest of the country, enlightened manufacturers and workers want to make everything that is required for war, but nothing beyond what is needed. They know that the readjustment must come and that the sooner it comes the better for all concerned.

Moreover, a tendency to view the reconversion prospect with greater optimism is in evidence. One reason for it is the showing of trade and employment to date. Despite the cutbacks and the decline in the production

indexes, trade has been excellent during June, with department store sales over the country during the first three weeks of the month showing an unseasonal gain over the May figures and an increase of 18 per cent over the same period a year ago.

Employment in the industries has declined but there are unsatisfied demands for workers in almost all centers. Latest estimates of the Federal agencies show no rise in unemployment and no great increase in the number on the unemployment insurance rolls, as compared with two or three months back. In this respect the statistics accord with the common sense estimate of the probabilities, for it is plain to everyone that the farms and the service industries of all kinds are understaffed and can offer jobs to great numbers of people, provided they are able and willing to work at practicable wage rates. In many of the industries themselves there is great need of more workers; the outstanding examples are the textile mills, the ship repair yards, the lumber camps, and the mines.

These needs of course supply no assurance that all the workers released from the war plants and the armed forces as the months go on can find jobs, or that areas of substantial unemployment around plants that are cut back will not exist. The latter are beginning to develop already. But the backlog of demand for help is reassuring and by the end of the year a good many plants which are now entering the reconversion period, and therefore releasing workers, will be taking them on again. These are all factors holding estimates of unemployment, at least until the end of the war, down to small figures. It is worth recalling that in late 1941, when the industries were converting to war production, there was much fear of "priorities unemployment" and many proposals for Federal aid to relieve it, but it turned out to be of insignificant proportions and the proposals died because the relief was not needed.

Faith in Industry's Resourcefulness

A second stimulant to confidence is the instinctive and well-founded faith which people have in the ability of American business men to overcome difficulties and get ahead, provided an incentive exists and their ingenuity and resourcefulness are free to operate; and this faith has been a strong influence on sentiment particularly since the declaration by Mr. Krug, discussed in this Letter last month, that the War Production Board will rely upon business men themselves, rather than upon blueprints drawn up in Washington, to smooth the reconversion path.

During the war there have been two major demonstrations of the resourcefulness of American industry. The first was the speed of the conversion from peace to war production. The second has been the surprisingly large volume of civilian goods turned out through ingenious recourse to new or substitute materials and new ways to save materials and labor. Problems of getting new machinery, procuring materials, retraining labor and others of a like nature also are capable of solution in great part by superior energy and resourcefulness. Faith in these qualities was not misplaced during the earlier periods of this war, which in itself is a good reason why reliance may be placed upon them now.

With respect also to that part of the reconversion responsibility which falls upon government, optimism has been on the increase. The tax bill now in process of enactment, which was described in this Letter last month, is a highly encouraging measure to aid the working capital position of industry through prompt payment of tax refunds and anticipation of loss carrybacks. Procedures for the settlement of terminated contracts have become steadily more efficient, and pre-termination planning in many cases will be a great time-saver in the clearance of war machinery and inventory from plants and in the preparation and payment of claims. These measures go far to ease concern over some of the most important reconversion problems.

Plans for Capital Expenditure

A third consideration strengthening business sentiment is perhaps the most influential of all. It is the widespread confidence that whatever the difficulties of the transition period may be, beyond it lies an unparalleled peacetime demand for goods of almost every description, — particularly the durable goods which have been made only in small quantities or not at all during the war, — for construction, and for industrial equipment. Manufacturers who see this demand pressing for satisfaction will leave no stone unturned in the effort to get their share, and this attitude implies a resolute and energetic attack upon reconversion difficulties.

The evidence that the industries have great plans for capital expenditure has been added to during the month by a report of the Department of Commerce, which on the basis of replies to a widely distributed questionnaire estimates that the manufacturing industries in the next twelve months plan to spend $4½ billion for plants and equipment. The Department emphasizes that these are plans, not commitments, and that for various reasons, among them inability to get materials, the expenditures may not all be made. As evidence of intention, however, the figure inspires confidence in the business outlook. It is nearly three times the prewar average and compares with a peak of $2¾ billion in 1929.

The Federal Power Commission has reported that the utility companies plan expenditure of $1 billion in the next year on plant and equipment, inventory increases and maintenance. Neither of these reports includes the railroads, residential construction, public works and highways, and the trade and service industries, which also have great needs and equivalent plans. The execution of these plans will be timed according to availability of labor and materials and the course of costs and prices, but the evidence is that they will be carried forward without regard to a moderate business recession in the transition period. The one thing that would cause them to be reduced or postponed, in our judgment, would be a rise in construction costs, or a failure to bring down costs where they are now considered exorbitant. For exorbitant costs of plant construction result in excessive costs for the product of the plant as long as it operates, due to the higher overhead that the product must carry.

If these plans come to fruition, along with the demand that is certain to be experienced for automobiles, new housing, and innumerable other consumers' goods, the difficulties of the transition period may appear in retrospect to have been short-lived and of comparatively little consequence. Business sentiment seems to be viewing them increasingly in that perspective. If the next few months should be disappointing and unemployment should rise and trade decline to levels not now expected, a reaction in sentiment and a period of hesitation doubtless would follow. The figures will bear watching, but at present the tendency is to look upon the bright side.

The Question of Costs and Prices

The question of what costs and prices are likely to prevail in the industries comes increasingly into view as the readjustment period begins. Policies of government, management, and labor are all involved, but the ultimate interest at stake is the interest of the people as a whole. The goal is to establish cost and price relationships on civilian goods which will encourage production, trade and employment, and at the same time to prevent the inflationary spiral from continuously mounting. The Price Control Act has been up for renewal during June, and although there has been little sentiment for terminating price control entirely, dissatisfaction with present conditions led Congress to amend the law. It provided specifically for revision of Office of Price Administration policies with respect to meats, and it obtained a written commitment from the Administrator that margins on major cotton goods lines will be widened. Also, O.P.A. powers over food prices generally were limited by requiring the prior consent of the Secretary of Agriculture to its decisions.

In taking these steps Congress was concerned by the evidence that O.P.A. prices have restricted production of meats and textiles particularly. The same concern should apply to all products for the civilian market.

Standards of Pricing

O.P.A. pricing of manufactured goods during the war has been based largely upon the overall earnings of the particular industry. Only when the return of the industry on net worth, before income taxes, falls below the prewar level are ceiling increases normally permitted. For industries making many products, higher prices are denied as long as total earnings meet the standard and out-of-pocket costs are covered generally for each line.

The appropriateness of these standards for use during the period of maximum war effort need not be debated now, but how they will work in a time of falling war production, when the problem is to get maximum output of civilian goods, is a question of urgent importance. The overall earnings of most industries since 1941 have been derived far more largely from war work than from civilian production, and in many cases earnings on war work have covered up losses, or lack of a remunerative profit, on civilian products. The tire manufacturers, for example, have made satisfactory overall earnings, thanks to their war work; but increasing costs, hitting against the ceiling prices, have squeezed the margins on civilian tires to unprofitable levels. The same situation exists in certain textiles.

When production of civilian goods is thus carried on without profit, the buyer of the goods is receiving a concealed subsidy, which is paid by the buyer of the war products, namely, the armed forces. This is an artificial and unsound condition. Unless it is remedied, and the prices allowed for civilian goods are set high enough to provide an incentive, their production will be discouraged. If one product does not carry its part of the overhead costs, and yield a margin of profit, producers will turn wherever possible to another. If the inadequate margins become general, the incentive to production generally will be weakened. If current production has to be carried on at a loss or unsatisfactory margin, there will be no inducement to expand, but rather to retrench.

Another aspect of the matter is that prices at which one producer can keep going may be ruinous for another, after his war work is finished. The "industry earnings standard" does not provide for these differences.

The Reconversion Formula

The O.P.A. provides that manufacturers turning from war to civilian goods may sell at ceiling prices already established, which usually date back to March 1942, or may request a new ceiling determined with 1941 costs as the base, plus lawful increases in basic wage rates and materials, plus 1936-39 average profit margins. The increases over 1941 costs will be calculated as a fixed percentage applicable to each industry. There are provisions for relief in special cases, and an alternative formula is provided for small manufacturers.

Adoption of this so-called reconversion formula is a recognition by O.P.A. that wartime formulas may be restrictive upon peacetime production. The new formula assumes, however, first that 1941 costs other than wage rates and materials need no adjustment, although compensation of salesmen, office workers and many other expenses will also be higher; and second that 1936-39 average margins and profits will operate now as an incentive to production. A third assumption is that volume will be greater than in 1941, and that selling and overhead expense per unit will be reduced accordingly. The O.P.A. also counts upon an increase in labor productivity, as compared with 1941, to relieve squeezes.

The assumption of a greater volume than in 1941 shows that O.P.A. is looking beyond the reconversion period to an expected postwar boom, and takes no account of the effect of prices on the speed of reconversion, or of the effects of possible operating losses before the predicted boom arrives. The assumption of increasing labor productivity also looks ahead, since the trend in many civilian industries during the war years has been the other way. Finally, the reliance upon 1936-39 average margins exposes a fundamental weakness of price control, since for administrative reasons the authorities are almost compelled to use historical bases for their decisions, which tends to freeze prices and profits in a historical pattern and destroy the flexibility which is the essence of change and progress.

Even if the stated assumptions are all realized, it will still be true that the standards of O.P.A. will be overall standards, and that to obtain relief for different products and different producers will be a costly and time-consuming process. One argument against moving from industry standards to product standards is that the latter are impossible to administer, due to the amount of work involved, the difficulties of cost determination and other complexities. However, this should not stand in the way of prompt relief for certain broad categories of products; and if piecemeal relief is administratively impossible the country would be better off in the long run to trust to competition and to manufacturers themselves to fix prices reasonably, rather than suffer loss of production by reason of restrictive ceilings.

From the public viewpoint the overpowering consideration is that production should go forward, to give employment, supply the markets and absorb the inflationary pressure, and that expansion should be encouraged, to resume historical progress in raising the standard of living. Price increases needed to cover costs are not in themselves inflationary, although costs to be sure may be on an inflated level. The important matter is that small price increases, granted promptly wherever they are necessary to carry on production, may avert scarcity and prevent greater price increases later.

Elements in Costs

The foregoing is not intended to suggest that price controls should be terminated before a better balance between production and supply of civilian goods is achieved, but rather that the administration of the controls should be practical and realistic, always with an eye to the effect on production. By definition, inflation is a condition of insufficient supply of goods relative to the supply of money. Therefore if the price controls are operated in ways which restrict production, the need for them will be perpetuated. It would be short-sighted and dangerous to allow prices to move unchecked in areas where price advances could not stimulate production, due to shortage of materials, labor or other causes. But it would be equally short-sighted to take the other extreme.

The way to keep control of prices is to keep control of costs. The dominant element in costs, following the chain of production back to the raw material, is the cost of labor. As long as the cost of living stands at present levels few people would suggest reducing basic wage rates, but there are other ways to reduce costs and keep prices down. The primary need is to reverse the wartime rise in labor cost per unit of output which has occurred in most of the civilian industries, and to turn the line downward not through wage cuts but through increased productivity.

The labor unions are asking increases in basic hourly rates to offset the loss of overtime pay that is in prospect. There is a body of opinion which holds that the industries could pay higher basic rates without advancing prices through prospective increases in productivity, elimination of overtime premiums, and shifts of workers from higher-pay to lower-pay classifications, — correcting the upgrading which has been so general through the labor shortage. This view overlooks the increase in selling and distribution costs that

will come in dealing with the general public instead of Uncle Sam, also the reduced volume and higher overhead when war work ceases.

Employers fear, moreover, that what is gained through weeding out inefficient workers will be lost through labor disturbances, restrictive union regulations, and similar factors. As between giving wage increases and receiving a more productive day's work on the one hand, and employing inefficient workers at current or even lower wage rates on the other, there is no doubt that the former would be the virtually unanimous choice. The question is whether all the elements in the industrial organization, and all the agencies formulating and administering government policy, will put the emphasis upon good hard work rather than upon money wages.

Seventh War Loan Results

The Seventh War Loan has passed the $23 billion mark as this Letter goes to press and indications are that total sales will exceed approximate $23 billion, surpassing any previous drive and topping the quota by some $9 billion. Sales to individuals, likewise reaching a new high, have met the individual quota of $7 billion, raised from $5 billion in the 6th War Loan, and may exceed $8 billion when all returns are in. Once again the determined effort of thousands of volunteer salesmen backed by enthusiastic leadership and publicity contributed by numerous business, professional and civic elements has helped to assure the successful outcome. The banks, although barred from participation in the drive on their own account, accomplished more than ever before in organizing and selling effort and in the handling of millions of separate subscriptions, with correspondingly greater results in sales to their customers.

The added length of the drive — six weeks against four previously for the active drive with inclusion of savings bond sales for three months instead of two as heretofore — was apparently a minor factor in the large sales, as nearly 80 per cent of the total was subscribed in June, with 60 per cent concentrated in the six days of June 18 to 23 inclusive. More important in the heavy over-subscription was the strength in the market for outstanding Treasury bonds of previous issues. In the six months since their issuance, the 6th War Loan 10-year 2s and the 26-year 2½s have risen to premiums of 3⅛ and 1⅝ points respectively, with accompanying advances by all other Treasury securities of intermediate or long-term maturity.

Sales of marketable issues alone have exceeded the entire 7th War Loan quota of $14 billion and have approximated sales of marketable securities in the 6th War Loan, notwithstanding greater restrictions on their sale this time. Purchases by individuals of marketable Treasury securities were far in excess of the $2.3 billion of the 6th War Loan, representing a greater proportion of all such purchases than last time. Sales of the 5½-year 1½s, though offered this time only to individuals, have apparently equalled or possibly exceeded sales of the 6th War Loan 2¾-year 1¼s to all buyers including corporations and institutions, and probably were seven or eight times as great as individuals' purchases of the 1¼s. Buying in the 1½s has undoubtedly been influenced by the fact that they constitute the longest-term 7th War Loan issue available for unrestricted commercial bank purchase after the drive.

In contrast to the enthusiastic reception of the marketable bonds, subscriptions to E bonds, best adapted for the small investor, totalling $3.1 billion as far as announced on June 28, have fallen short of the enlarged quota of $4 billion, although they are running well ahead of results of the 6th War Loan. Counting the net of sales of war savings bonds over redemptions, the 7th War Loan so far is only moderately ahead of the 6th and falls below the 4th and 5th, despite the greater length of the present drive. It had been hoped to make an especially good showing in E bond sales, since this security affords a particularly good medium for absorbing the excess of consumer purchasing power over the available supply of consumer goods.

Extent of Bank Credit Involved

It is obvious that no such vast amount of securities could be sold six months after a drive of comparable magnitude without extensive rise in the use of bank credit. This is clearly reflected in the banking figures thus far available for the period of the drive.

From May 2 to June 20, all weekly reporting member banks' loans to brokers and dealers against governments increased from $749 million to $1,729 million, with banks so far reported (New York City and Chicago only) for the week ended June 27 showing a further rise of $123 million. At the same time loans of these banks to others than brokers and dealers against governments expanded between May 2 and June 20 from $604 million to $2,035 million, with a further $95 million advance in New York and Chicago in the following week. These increases are much larger than occurred in previous drives and carry the totals to levels well above previous peaks. Ordinarily a substantial portion of these loans is liquidated out between drives.

Accompanying this expansion of loans, weekly reporting member banks added $3½

billion to their own holdings of government securities, giving a combined increase of loans against governments plus direct purchases of approximately $6 billion. An interesting feature of these figures was the increase in the proportion of credit extended through the medium of loans rather than through direct purchases of securities.

On the basis of the foregoing figures, admittedly incomplete, it would appear that expansion of commercial bank credit for the country as a whole over the period of the drive may have approximated 50 per cent of the increase in the national debt. Counting also the $1,215 million increase in Federal Reserve holdings of government securities the ratio of course would be higher.

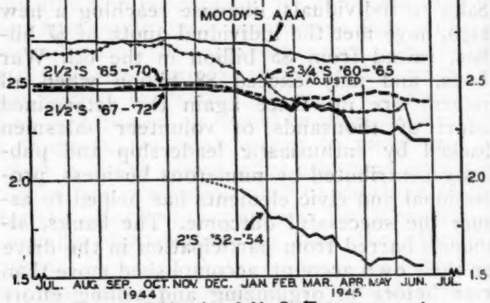
The Decline in Interest Rates

The market for outstanding government securities has continued to reflect the flow of commercial bank funds into the longer-term higher-yielding issues. While this tendency stems basically from a growing confidence among investors generally that they can't be hurt reaching out into the longer maturities, as recorded at some length in the March issue of this Letter and again more briefly a month ago, it has received added stimulus since the announcement of the terms and conditions of the 7th War Loan. These greatly restricted the volume of intermediate and long-term securities available to banks, either on subscription or by purchase in the market. Not only were the commercial banks again — as in the 6th War Loan — excluded from subscribing any portion of their commercial deposits, but even their already limited right to participate in proportion to savings deposits was further restricted by excluding the marketable 2¼s and 2½s, thus leaving available to banks only F and G savings bonds, ⅞ per cent certificates, and 1½ per cent bonds — and even these in amounts limited, as before, to 10 per cent of savings deposits or at the maximum $500,000.

With these restrictions upon subscription to new issues, banks seeking an outlet for their funds have been forced to turn to issues already traded in the market. At the same time, the supply of bonds coming on the market from secondary sources, particularly institutional investors, has been cut down by the Treasury request not to sell existing issues in connection with war loan subscriptions except for "normal portfolio adjustments," and by the limiting of subscriptions to the new 1½ per cent bonds to individuals (except for the small amounts permitted against savings deposits in commercial banks).

The banks, in consequence, anticipating a scarcity in the floating supply of the intermediate maturities needed to sustain earning power, have sought to build up their portfolios out of existing issues available in the market. While Treasury securities of short maturity have been relatively neglected, and prices (except for bills which are pegged by the Federal Reserve Banks) have tended at times to sag, intermediate and longer maturities eligible for bank investment have been in heavy demand, with some banks reaching all the way out to the 2½s of 1967-72 and forcing that issue to a 2.19 per cent basis. These declines along the greater part of the yield curve in the bank eligible list raise a question as to their ultimate effect, if continued, upon the entire structure of interest rates.

Already, as shown by the accompanying diagram, yields on partially-exempt issues eligible for bank investment have been affected. Return on the partially-exempt 2¾s of 1960-65 (adjusted in the diagram to a fully taxable basis for purposes of comparison) dropped fairly abruptly in June, pulled down by the further decline in the yield of the bank eligible 2½s of 1967-72.



Trend of Yields of U. S. Treasury and High Grade Corporation Bonds

(Treasury bonds include bank eligible 2s of 1952-54 and 2½s of 1967-72, both fully taxable; bank eligible 2¾s of 1960-65, partially tax-exempt but adjusted to a fully taxable basis; and bank ineligible fully taxable 2½s of 1965-70. Weekly plottings, latest date June 28.)

While thus far the yields of long-term governments ineligible for bank investment (as exemplified in the 2½s of 1965-70) and of triple A corporates have failed to show declines comparable with those of bank eligibles, it remains to be seen how long these widening spreads can persist. Should a continuing scarcity of intermediate issues force a further decline in yields in this maturity range, there will be strong temptation for non-banking investors ordinarily favoring these maturities to stretch out their investments into the long-term bank ineligible 2½s and high grade corporates still yielding relatively high rates. This might be accompanied by some spilling over of bank funds into high grade corporates if yields on the long-term bank eligibles go lower.

Effects of Too Low Interest Rates

Such moves, to the extent that they take place, would exert pressure on yields of high grade corporates and long-term government issues not eligible for commercial banks, and might eventually drive these rates also to lower levels. This would mean cutting still further the rates upon which insurance companies, savings banks, charitable and educational institutions, trust and pension funds, and other long-term investors depend. It would tend to divert investment money into more speculative employment and promote inflation. There is no doubt that the recent advances in stock prices and in real estate, which have been causing so much concern in Washington, are in part a reflection of the decline in interest rates.

Chairman Eccles, of the Board of Governors of the Federal Reserve System, stressed the deleterious effects of letting interest rates get too low when he said in a speech in the late Fall of 1940:

> **Excessively low interest rates tend ultimately to induce inflated prices of governments, municipals, and other high grade securities. The effects are reflected in credit lines generally, and are felt by insurance companies, savings banks, educational institutions, and other fiduciaries representing the accumulations of many millions of our people, small as well as large savers.**
>
> **Moreover, this creates a future problem for monetary authorities because at such time as it may become necessary to curtail further credit expansion, as a safeguard against inflationary developments, this step cannot be taken without causing a decline in the price of outstanding securities.**

Only little more than a month after the above statement by Chairman Eccles, a special report to the Congress by the Board of Governors of the Federal Reserve System, the presidents of the Federal Reserve Banks, and the Federal Advisory Council contained the following declaration:

> **Because of the excess reserves, interest rates have fallen to unprecedentedly low levels. Some of them are well below the reasonable requirements of an easy money policy, and are raising serious, long-term problems for the future well-being of our charitable and educational institutions, for the holders of insurance policies and savings bank accounts, and for the national economy as a whole.**

It should be possible to lessen the danger of further decline in the long-term investment rate, with injurious effects as described, by either (a) unpegging the short rates and allowing them to advance, thus attracting more bank funds into the nearer maturities, or (b) increasing the supply of intermediate issues and making them available to banks — preferably by direct offerings after the drives — which would satisfy their needs without bidding up prices and forcing down yields of outstanding issues. While a desire to limit bank earnings has been indicated to be responsible in part at least for the present official policy of restricting the supply of securities available to banks to the short, low-yielding maturities, it may be questioned whether this constitutes wise policy, especially in view of the collateral effects upon the general structure of interest rates outlined above.

Undoubtedly a helpful factor in preventing a further decline in long-term interest rates generally would be for the Treasury to make clearer its intention to continue issuance of 2½ per cent bonds in subsequent war loans.

British Reconversion and Balance of International Payments

With peace restored in Europe, Great Britain, like the United States, is entering a period of limited reconversion to peacetime production. Her people are facing formidable tasks, for Britain, to a much larger extent than we, has diverted her manpower and her plant and equipment to the war effort. In contrast with this country, the very materials for reconversion, as well as food, must come largely from overseas and be paid for at a time when Britain's purchasing power has been drastically curtailed by the loss of export markets, by the liquidation of foreign assets, and by reduced income from shipping and commissions.

Yet the solution of these problems is vital not only to Britain but to the world. Britain has been and is a great center of world trade and finance on which many other countries depend. Her experience in dealing with problems of international trade and finance will be needed in holding this network together, and in helping to repair the devastation wrought by war.

Not only is Britain our best customer but the world's best customer as well, absorbing before the war almost one-fifth of total world imports. Including the group of countries which have linked their currencies with sterling — the so-called "sterling area" — there is represented something like one-third of the world's import trade. Manifestly, what happens to Britain and the pound sterling will determine in large degree the shape of world trade and currency relationships to come. It is at the core of the Bretton Woods problem. For until the free convertibility of sterling in terms of foreign currencies is reestablished on a sound balance of payments position for Great Britain, our ability to achieve the postwar objective of a stable international currency system, freed from exchange controls, will be limited.

The British Position Today

What then is the magnitude of the British exchange problem? Briefly the picture is as

follows, giving latest available or estimated figures now and figures before the war:

British Balance of Payments in 1937-38 and Certain International Transactions in 1943*

(In Millions of £)

	1937-38 Average	1943
Total merchandise imports	906	1,865
Imports excl. "munitions"**	***	1,211
Merchandise exports	496	232
Adverse trade balance	—410	—1,633
"Invisibles"		
Income from investments	205	100†
Shipping income	115	n.a.
Other income and miscellaneous	35	n.a.
Total services	355	n.a.
Lend-lease and mutual aid	.....	750‡
Disinvestment (sale of overseas assets and net borrowing abroad)	55	684
Total balance	— 55	—1,434

* Principal Source: Board of Trade Journal and The 1945 Budget White Paper. **"Munitions" include aircraft and other vehicles, arms, ammunition and military and naval stores. ***Not reported separately. † Based on estimate of Sir Stafford Cripps, quoted in (London) Bankers' Magazine. ‡ As calculated by The (London) Banker. n.a. Not available.

It will be seen that value of imports excluding "munitions" was up 34 per cent from prewar total of imports to £1,211 million for 1943; and presumably the total for 1944 was at least as large. This increase, however, was due entirely to the rise of prices. Actually on a volume basis, imports were down by 21 per cent — a reduction which, in the face of the war industries' requirements, is attributable to rigid control of imports and drastic limitation of civilian consumption.

As against this expanded cost of imports, exports by 1943 fell 53 per cent in value, and 71 in volume, to a total of only £232 million. Here we have the effect in part of the shutting off of certain export markets by the war, but mainly of a deliberate sacrificing of British export trade in the interest of the total war effort. That Britain has been able to cut exports to the bone has been largely due to American lend-lease and Canadian mutual aid which provided essential war materials without the necessity of exports to pay for them. Thus, lend-lease and mutual aid, far from helping to promote British exports, as sometimes charged, have made it possible for Britain to nearly eliminate them and to work all the harder on war output.

At the same time that merchandise exports have fallen, income to Britain from her so-called "invisibles" has likewise declined. Great Britain has parted permanently with some £1,100 million of her foreign investment stake, due both to liquidation to procure foreign exchange, and to repatriation of British-held securities. It is expected that in the immediate postwar years the income from the regular "invisibles" will be down to about one-half of the pre-war figure, or to about £180 million.

In 1943, "invisibles" included large expenditures by American soldiers in Great Britain, as against British expenditures for troops overseas reported in the latest budget speech at £689 million. The actual 1943 cash deficit in merchandise trade is also unknown since even the imports other than "munitions" include some lend-lease or mutual aid imports, while exports include reciprocal aid shipments other than "munitions". However, it seems that the overall deficit in Britain's current account transactions in 1943 was about £1,434 million. As will be seen from the table above, about £750 million was covered by lend-lease and mutual aid and £684 million by the sale of overseas assets and net borrowing abroad.

Growth of Sterling Indebtedness

Besides being obliged to sell off a large share of her foreign investments, Great Britain has been forced to go heavily in debt for that portion of her huge overseas war expenditures not covered by export proceeds or lend-lease or mutual aid arrangements. This indebtedness has taken the form of "sterling balances," part of which would normally have been converted into goods for export had they been available. Early this year these balances, which are a modern counterpart of the Interallied debts of World War I and which consist largely of deposits and investments in British Treasury bills, had reached £3 billion ($12 billion), as compared with around £350 million of foreign balances in London before the war, and the amount is still rising. Counting both the loss of foreign resources and growth of sterling indebtedness the net deterioration of Britain's external financial position has mounted already to nearly $16 billion, and may well exceed $20 billion before war costs can be brought under control.

These figures are eloquent testimony to the unsparing manner in which Britain has spent her substance in defense of the Empire and in furtherance of the common war effort. They emphasize the magnitude of Britain's postwar exchange problem. Besides bridging the gap in her current accounts, she must come to some settlement with the holders of the $12 billion plus of sterling balances who will be clamoring for release of their funds from the exchange control in order to buy capital goods wherever obtainable during the reconstruction period.

While any plan for repayment must obviously extend over a period of years, some portion of these vast sterling claims will doubtless have to be made available to their owners for general use fairly promptly. To the extent that this is done, it means that much extra

strain upon the British balance of payments at a time when Britain will be needing every dollar or its equivalent in foreign exchange that she can scrape together to cover her current trade deficit and pay for the material needed for reconversion.

The question is, where is this money coming from?

Cash "In the Till"

First, consider cash "in the till". How much gold and foreign exchange has Britain on hand?

According to the latest official disclosure made in the Fall of 1941, when Great Britain was scraping the bottom of the barrel, official holdings of gold and dollar exchange were down to the equivalent of about £50 million. Since then, however, part of the Empire's newly-mined gold has been retained by London, and London has been accumulating dollars in the "dollar pool" in which sterling area gross dollar earnings are concentrated and from which member countries' essential needs for dollars are satisfied on an agreed basis. How large these gold and dollar holdings are is a well-guarded secret. One clue to their size would seem to be a comparison of Britain's *gross* sales of overseas assets including the prewar gold reserve, and increase in short-term overseas debt, as reported from time to time and amounting to £4,300 million in 1939-44, with the *net* borrowing abroad and sale of foreign assets of £3,850 million as reported in the latest budgetary White Paper. This would indicate retained gold and foreign exchange assets of the United Kingdom amounting to roughly £450 million ($1.8 billion) at the end of 1944, presumably mostly gold and dollars.

While this, if approximately correct, may seem like a large sum, it is small in relation to Britain's indicated postwar balance of payment deficits and other heavy overseas obligations. It is small for working reserves for Britain and the sterling area if Britain is to play her full part as an international money center and be in position to relax exchange controls. Clearly, cash "in the till" is no answer to the problem.

Opportunities for "Tightening the Belt"?

Secondly, what about Britain "tightening her belt" on consumption and reducing imports during the transition period?

Here the chances appear slim. Even under the wartime regime of severest economies, with food shipments cut almost 50 per cent, it has been possible to reduce import volume only about 20 per cent.

Probabilities are that imports during the transition period will have to be considerably larger than before the war, despite Great Britain's greater measure of self-sufficiency in food and certain substitute industrial products. Large quantities of raw materials will be needed for restocking and to get the industries going on peacetime goods for the domestic market and for export, and prices will be higher than in prewar. With one-third of 13 million houses in the United Kingdom affected by enemy action, large imports of construction materials will be necessary. People will be wanting to buy some of the things they have been so long without, particularly as they will have the necessary purchasing power. Since 1940, consumers' expenditures in Great Britain have averaged 20 per cent in real terms below 1938, with clothing purchases some 40 per cent off during the same period.

Taking account of these pent-up demands and of the fact that considerable unemployment existed in prewar years, it is easy to foresee a volume of postwar British imports substantially above prewar even with a continuation of import controls of some severity. This would be especially true under conditions of full employment, which seem certain to prevail in view of the vast amount of work to be done.

The Drive for Increased Exports

Since cash on hand is no answer and since it will be impossible to reduce imports without making serious inroads in the standard of living, it is clear that exports must be brought up. Yet to pay for a prewar volume of imports, which at 1944 prices would cost £1,580 million, and to make up for the loss of "invisibles," merchandise exports would have to be 50 per cent higher in volume than before the war. This means that at 1944 prices exports would have to total £1,250 million, a five-fold increase from last year's actual figure. To the extent that imports are allowed to rise above the prewar level, exports of course would have to be increased proportionately; and still this does not leave anything for paying down sterling indebtedness.

The task of expanding exports 50 per cent by volume over prewar would be stupendous under normal conditions, let alone during a period of reconversion from war to peacetime production. During the early stages after the war the difficulty will not be to find an adequate demand for British goods. The limiting factors will be those of production and shipping. Certainly this will be true so long as the Pacific war lasts; but even after that British recovery will take time and be more difficult than our own.

We have already referred to the extent to which Britain's economy has been converted to war, including the practical suppression of exports. More than 4,000 plants have been closed as unessential or telescoped under the concentration scheme, and well over 10 million men and women, or more than a third of the adult population, have been mobilized for

military service or for work in the munitions industries. Even cripples — "unemployables" — have been combed over, and out of 187,000 turned up some 169,000 have been rehabilitated for productive purposes. The conversion to war effort has been most complete in the steel and machinery industries, the very ones upon which the British particularly depend to contribute to postwar expansion of exports. All this points to tremendous readjustment, complicated by the need of providing some 600,000 emergency housing units over the next two years for the bombed-out population.

That the British realize the importance of overcoming these handicaps and getting exports going at the earliest possible moment is evident both in government policy and in discussions in Parliament and in the press. With the ending of the European war and partial relaxation of wartime restrictions, domestic consumers are being asked to share the meager trickle of new civilian products from the factories with the export market. In the case of automobiles half of the 200,000 private cars authorized for production in the next twelve months are to be allotted to exports. Raw materials for use in the export industries are to receive high priority under the import controls. The London Economist, reviewing export prospects at some length in its issue of May 19, urges an effort to raise the volume of overseas shipments during the next twelve months to at least 50 per cent of the 1938 volume, as compared with only 31 per cent in 1944, and suggests that each industry be given an export goal which should be adhered to against pressure to sell at home.

Need for Foreign Credit

Meantime, Great Britain will need outside assistance to tide over a difficult period. Although she is at present receiving substantial lend-lease aid from the United States in connection with the war with Japan, no provision has been made for extending such aid beyond V-J day. Barring further assistance of the lend-lease kind, it is clear that Britain must borrow, and such borrowing might take various forms, to wit —

1. Increase in ordinary commercial credits by American and other non-sterling area banks. While such credits would be short-term and for financing the shipment of goods with a ready turnover, their expansion from present wartime lows to a more normal volume would constitute in the aggregate a net gain in the use of credit financing British imports.

2. Increase in sterling balances. This, however, if patterned on the wartime system, would be in danger of crystallizing that system, and would not be in the direction of a freely convertible sterling.

3. Loans at large — either intergovernmental, or open market with or without guarantee by governments or possibly by the International Bank for Reconstruction and Development if set up, or some combination of these. While Great Britain understandably is reluctant to borrow and increase her commitments in foreign currencies, nevertheless some borrowing of this nature may be in the interest not only of Britain but of the rest of the world if it leads more quickly to abandonment of discriminatory trading arrangements and relaxation of exchange controls. Her decision with respect to borrowing would no doubt depend in the end upon her estimate of the prospects of servicing such loans, and upon the conditions of such borrowing — that is, whether they would give promise of really contributing in the long run to the solution of her exchange problem.

To be most effective such loans should not be "tied" in the sense of having to be spent for goods in any particular country. London should be in a position to be a lender as well as a borrower if she is to restore her trade and resume in full measure the duties and responsibilities of a great money center. The point that needs bearing in mind is that the restoration of a sound British trade position and of a freely convertible sterling is a key part of any program of world recovery. It is realization of this that has led to suggestions in this country that the United States be prepared to extend to Great Britain after the war a substantial direct grant of funds to aid in stabilizing her economy.

The Longer Range Position

In the natural concern over the difficulties immediately ahead, it would be easy to overlook that Britain's balance of payments problem is not purely a matter of the somewhat vaguely defined reconversion period. Even before the war Britain was having trouble maintaining her international accounts in equilibrium, as evidenced by the foregoing table showing a moderate deficit for 1937-38 that had to be covered by borrowing or by sale of gold or other assets. Conditions of trade, both as to markets and as to products, were undergoing great changes. British cheap coal, always a major export item, was running out. At the same time other products were affected by industrialization and technological developments throughout the world. Between 1913 and 1937 British coal exports fell from £50.7 million to £37.6 million, cotton yarns and manufactures from £126.5 million to £68.5 million, and iron and steel and manufactures thereof from £55.4 million to £48.4 million. Inertia in adapting to change and failure to keep pace in technological improvements in certain important sectors of industry, as revealed in various British surveys, have been factors in international competition.

The war has effected additional and even greater changes in British markets overseas. The trend towards industrialization was accelerated. Most serious has been the weakening of the British balance of payments through liquidation of foreign investments. All these are long range problems — influenced by, but extending beyond, reconversion — which have caused some responsible people in England to doubt Britain's ability to find their solution without permanent controls over her internal economy and foreign trade and exchange.

Fortunately, there is a more hopeful side. The recovery in current account receipts may be larger than now foreseen. The tourist industry may eventually develop into a more important source of foreign exchange than ever before. There should be a pick-up in income from foreign investments once the enemy occupied areas are recovered, and in ship earnings, considering that Great Britain will emerge from the war with a merchant marine, despite losses, equal to 75 to 80 per cent of prewar. There is expectation of a gain in British trade through elimination of German and Japanese competition, but this could easily work two ways as both countries have been important purchasers of world products.

More important than the above have been the enlargement of British productive capacity during the war, and all-around stimulation of more advanced technique and productive efficiency. Nor should there be overlooked the development, well under way before the war, of various important newer industries — chemicals, electrical equipment, rayon, and others — which were already making their way in the export field and whose methods rank in the forefront with those employed anywhere. Finally, there is the skill and resourcefulness of the British people, and their long experience as world traders, which can be brought to bear as the challenge becomes more evident and they set their minds to meeting it.

In the postwar development of exports it is desirable that progress be made as far as possible along lines that promise some permanency rather than along those which, though momentarily inviting, may call for readjustments later. This is a problem that Britain will have to face, but other countries not so hard pressed for immediate exports will be able to resist temptation more easily.

Need for Understanding

The hope is that solution of the postwar problems will be sought in directions looking towards long-run reestablishment of liberal trade policies. This will require a world economy that is expanding, with more trade flowing all around and a general willingness on the part of all countries to contribute towards reduction of trade barriers and elimination of discrimination in international commerce. The sound administration of the Reciprocal Trade Agreements Act, recently reenacted with enlarged scope by the Congress of the United States, may well be an important step towards this objective.

To be successful in developing harmonious and mutually beneficial trade relations, the transitional problems will have to be worked out in an atmosphere of forbearance between all parties. Potentialities of misunderstanding and friction are only too apparent in connection with the sterling indebtedness and the limitations as to trade and exchange under which Britain will have to operate in the transition period.

As to external sterling indebtedness, a duty obviously must be to find a solution fair to the creditor but which at the same time recognizes the realities of the British balance of payments position and the problem of developing the surpluses necessary for servicing large international obligations. We in this country have an obligation for tempering natural postwar trade rivalry with appreciation of Britain's special problem of exports, as well as her need for import and exchange controls during her critical transition period. Britain, on her part, must convince America that methods used to solve the transitional difficulties do not discriminate against American interests, and that the processes of unwinding the restrictive wartime system are proceeding as rapidly as possible.

In conclusion, it seems appropriate to quote remarks by the governor of the Bank of England, Lord Catto, at a luncheon given by the Lord Mayor to the bankers and merchants of the City of London last Fall. He said in part:

> I am frequently asked whether this country can regain its old financial and industrial leadership. Well, I am full of quiet confidence. It is true that our national debt is likely to be about three times as much as it was at the end of the last war. It is true also that part consists of obligations to overseas countries of an important amount. All that is a heavy burden. But the productive capacity of the country and therefore the national income have also very substantially increased since the end of the last war. Recovery will not be easy; it will require much effort, much restraint, and, to use historic words of our great Prime Minister, much "toil and sweat" to make full use of our productive capacity. However great the effort, it will have its compensations, for, if guided aright, it will assist that full employment policy to which the Government is committed, and with which we are all in such ardent sympathy.
>
> But, My Lord Mayor, recovery will need something more; it will need a resurgence of that individual initiative, that resourcefulness, and that spirit of adventure which, in war and in peace, have ever, of old, contributed to our country's prosperity and to its greatness. In that respect the City of London must give a lead and play a major part. I do not need to tell you that her position in world commerce and in finance is unique — and I would ask you to note, I say "is" not "was."

It is this philosophy and this courage that have made Britain great.

From firing line to deposit line ...at Manila!

Both fortress and observation post for Yank battalions during the fight for Manila, the National City branch once again resumes its pre-war place in world-wide banking.

FOR NEARLY three weeks after the entry of General MacArthur's troops into Manila this spring, elements of the 37th Division fought a front-line battle with the Japanese from the six-story building which, until Japanese occupation, was the home of the National City branch.

American machine gunners blazed away at enemy snipers from the Bank's lower floors. Upstairs—on the sixth floor—artillery COs gave the fire directions that blasted the enemy-held Manila Hotel and other strongholds in the Walled City across the Pasig River.

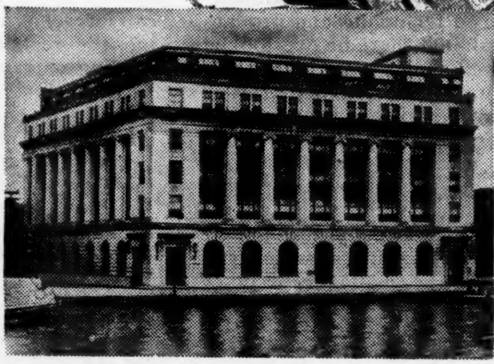
But today, with victory, the picture is changed. This building on the Calle Juan Luna once more is open for banking business.

The only American bank in the Islands before the war, National City in Manila is the only one there now.

GI Joes who just a while ago were fighting in the Bank, now call to cash their checks. The Bank's staff is busy putting its 43 years' experience in the Islands to work—aiding reconstruction and helping to stimulate the renewal of trade with the States. You can transfer $10 or millions of dollars from New York to Manila today.

The National City branch in Manila is part of this Bank's World-Wide Banking System which, for decades, has been handling business and financial transactions for exporters and importers. Both in the number of foreign branches and in the size of its staff, this overseas organization leads all American banks. The Bank provides credits, exchange and up-to-the-minute information on markets all over the globe.

To find out how these widespread facilities can assist in your operations in the Philippines or anywhere else in the world, consult our officers at Head Office or Branches in New York.



Overlooking the Walled City (Intramuros), and the Port District, the National City Bank building in Manila made an ideal OP for American battalions. Machine gunners discouraged enemy troops who tried to cross the Pasig River.

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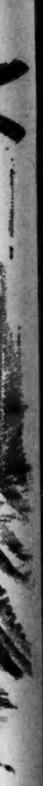

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